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## Government Regulation of Railroad Finances \*

BY EMORY R. JOHNSON

A justification for the discussion of the government regulation of railroad finances is found in the very size of the task. The official valuation placed upon railroad property in the United States is approximately twenty-five billion dollars. The reproduction cost of this property would probably be once and a half the official valuation. To maintain this property and to keep it abreast of technical requirements and to provide for necessary new facilities requires an annual investment of seven hundred fifty million dollars.

The importance of the government regulation of railroad finances grows out of the fact that the railroads and other agencies of transportation are a fundamental and vital necessity. Upon adequate transportation depends the welfare of society, economic activity and progress, and the stability and efficiency of governmental administration. These facts have been so often set forth that it is necessary only to refer to them without discussion.

The reasons why the government of the United States has undertaken the regulation of the finances of railroads are to be found partly in the facts just stated. The railroads are one of the essential utilities by which the public is served. Indeed, the railroads are the most important of all the utilities, and their financial administration and development are of concern to the entire public. Moreover, the investments in the railroads, both by private individuals and by fiduciary institutions should, in the interest of the public, be as safe, stable and non-speculative as is practicable to make such investments by wise government supervision. At the present moment insurance companies, trust companies and other similar institutions are much concerned as to the financial condition of American railroads.

The government regulation of railroad finances began with the regulation of railroad accounts. The original interstate commerce act of 1887 gave the interstate commerce commission authority over the accounts of the carriers subject to the act; but, as no provision was made for enforcing any system of accounts that might be prescribed by the commission, no system was

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prescribed and the accounts remained unregulated until the passage of the Hepburn act in 1906. This act gave the commission the power not only to prescribe but to enforce uniform accounts and with the coöperation of the Association of Railway Accountants, the commission, with the expert assistance of Henry Carter Adams of the University of Michigan, worked out a uniform system of accounts first for the railroads and then for other carriers subject to the interstate commerce act. Dr. Adams remained at the head of the bureau of accounts of the commission for a number of years, and to his wisdom and ability the subsequent success of the supervision of railroad accounting is largely due. The bureau of accounts of the interstate commerce commission has functioned successfully and with the complete coöperation of the carriers subject to the commission.

Further indirect control by the interstate commerce commission of the finances of railroads was given by the Mann-Elkins act of 1910 which gave the commission practically complete authority over the revenues of the carriers. The Hepburn act had given the commission the power to fix a maximum rate upon the complaint of an interested party. The Mann-Elkins act gave the commission not only the authority to consider rates upon its own initiative, but the still more important power of suspending proposed rates until the commission was satisfied that the rates in question should go into effect. Ten years later, by the transportation act of 1920, the commission was given authority over minimum rates and at the present time it is the commission rather than the railroad directorates that determines rate levels and consequently the revenues of the carriers.

The direct regulation by the government of railroad finances was provided for by the transportation act of 1920, but one needs to go back ten years to discover the origin of the provisions of that act. When at the close of 1909 the Taft administration recommended to congress amendments to strengthen the interstate commerce act one recommendation was that the commission be given authority to regulate railroad finances. The opposition in congress prevented the adoption of this recommendation, but President Taft was authorized to appoint a commission to investigate and report upon the subject of the government regulation of railroad finances. The chairman of the commission appointed was President Arthur T. Hadley, of Yale University. Under his very conservative leadership, the Hadley commission recom-

mended publicity of railroad finances without government regulation.

Some of the states provided for the publicity of the facts regarding the issue of railroad securities, but publicity proved ineffective. Indeed, experience showed that the states, no matter how thoroughly they might regulate the issue of railroad securities, were unable to deal effectively with the problem. This was shown by the action taken by the Mellon administration of the New York, New Haven and Hartford Railroad. The state of Massachusetts and the state of New York had provided for the regulation of the issue of railroad securities but the New Haven railroad was a Connecticut corporation and Connecticut had not provided for the regulation of railroad finances. Mellon was thus able to issue new stock without government restraint and the debacle that followed is well known.

The transportation act of 1920 provided for a comprehensive and complete regulation of railroad finances by the federal government. There are indeed four phases of the government regulation of railroad finances under the act of 1920:

First—The construction of new lines, and thus the expenditure of funds therefor, must meet with the approval of the commission and every railroad company is obliged to prove conclusively that public convenience and necessity require the proposed construction.

Second—The interstate commerce commission must give its approval to the abandonment of lines in existence. This is in effect a negative regulation of railroad finances because it gives the commission authority to require a railroad to spend such funds as may be necessary to maintain unprofitable branches or facilities whose operation in the judgment of the commission, is necessary to the public.

Third—The act of 1920 gives the commission complete authority over railroad consolidation and the financing of such consolidation. The purchase of one railroad by another must be approved by the commission. If securities need to be issued to effect the purchase such securities must be passed upon by the commission. If two or more railroads are consolidated into one system the capital of the consolidated system must not exceed the aggregate value of the properties brought together. Indeed, it is not an exaggeration to say that the real regulation of consolidation is through the commission's control of the financial operation involved in consolidation.

Fourth,—and principally—The act of 1920 provides for the regulation of railroad finances by giving the interstate commerce commission authority over the issue of securities. It is interesting to note what the policy of the interstate commerce commission has been as regards the regulation of railroad securities. As would naturally be expected, the commission at first acted by approving or denying applications without suggesting modifications of the applications. Regulation was thus negative rather than constructive in character. Within a few years, however, it became more and more the policy of the commission to fix a price at which bonds might be offered for sale if their issue was approved by the commission. The commission thus substituted its judgment for that of the railroad directorates as to financial policy. In view of the fact that market levels seldom remain stationary for any considerable length of time it is necessary for the commission to act promptly upon applications for the issue of securities if the commission is to determine closely the price within which such securities shall be marketed. It is to the credit of the commission that it has acted promptly and I think it will be generally agreed that on the whole the commission has acted wisely. The third stage of the policy of the commission in the regulation of railroad securities has been the exercise of its judgment as to the kind of securities that may be issued, whether and to what extent securities shall consist of stocks or of bonds. In many instances the commission has required the applicants to substitute stocks in part or in whole for proposed issues of bonds. Here again the commission is substituting its judgment for that of railroad directorates as to financial policy.

What should be the policy of the interstate commerce commission as to the regulation of railroad finances? What is required in the public interest? There are at least five requirements:

The first necessity of the railroads is adequate revenues. Indeed, the regulation of railroad finances begins with the regulation of railroad rates and other sources of revenue. The transportation act of 1920 gives the commission the mandate to establish and adjust rates so as to yield carriers, under economical and efficient management, a reasonable return upon a fair value of their property. The commission is to fix a fair value and the annual rate of return. The commission has made a tentative valuation of the railroads and has established  $5\frac{3}{4}$  per cent. as a reasonable annual return upon such value. As is well known, however,

economic conditions have prevented the carriers from obtaining this rate of earning. At the present moment they are probably securing less than a third of  $5\frac{3}{4}$  per cent. per annum upon the value of the property used in the service of the public. Presumably present conditions are temporary and railroads as well as other industries will see better days in the not distant future.

Second, another requirement as to government regulation of railroad finances is that the government requirements as to expenditures by the carriers shall be reasonable. The interstate commerce act as amended to date gives the interstate commerce commission authority in numerous instances to require expenditures on the part of the carriers. On the whole, the commission's policy has been conservative and there have been but few complaints on the part of the carriers as to the commission's requirements. Indeed, the commission has more often prevented railroad corporations from making expenditures than it has made demands upon the carriers for outlays to carry out the provisions of the interstate commerce act.

A third requirement as to railroad finances is that the taxation of the railroads shall be equitable as compared with other properties and particularly as between the railroads and other competing carriers. Railroad taxes have risen year by year until 5 per cent. or more of railroad revenues is taken by the government. During the current year the government will take more than that percentage of the railroad revenues. This again is a temporary situation, but in the public interest it seems that federal, state and local governments should give serious consideration to the tax burden they are placing upon American railroads.

A fourth requirement as to the policy to be pursued in the regulation of railroad finances is that such regulation should be constructive and affirmative rather than negative as regards railroad consolidation. While it is realized now that more was expected in 1920 of railroad consolidation than it was possible to obtain, it is, nevertheless, true today that substantial economies of operation, administration and finance would result from the grouping of the railroads of the United States into a limited number of large systems of relatively equal financial strength and operating efficiency. The attitude of the interstate commerce commission towards proposed consolidations has become increasingly critical year by year and, on the whole, its present policy is more negative than constructive. This is unfortunate.

Fifth—It is of supreme importance that in the government regulation of railroad finances there should not be an undue limitation placed upon private initiative. The government should not take over the financing of railroads. The railroad directorates should continue to exercise their business judgment as to what is or is not wise. The substitution of government for private ownership and management of railroads would be a great mistake. To carry the government regulation of railroad finances to the point of substituting complete governmental control for private control of railway financiering would be disastrous to the development of American railroads, at least as long as their ownership is left with private corporations. The general purpose of the government in the regulation of the finances of railroads should be to establish the rules and to allow the railroads to play the game according to those rules. The railroad directors and officers should be in the game, the government officers on the sidelines.